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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1941

No. 283

BUTLER BROTHERS, a corporation,

Appellant,

vs.

CHARLES J. McCOLGAN, as Franchise Tax Commissioner of the State of California,

Appellee.

ON APPEAL FROM THE SUPREME COURT OF THE STATE OF CALIFORNIA

BRIEF OF APPELLEE

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Appellee.

The Opinion of the California Supreme Court is reported in 17 Cal. (2) 664, 111 Pac. (2) 334. The opinion of the California District Court of Appeal, which was vacated by the California Supreme Court, is reported in 102 Pac. (2) 776.

STATEMENT OF THE CASE

The statement of the case in appellant's brief, setting forth the stipulation of facts, is accurate and appellee accepts it, with exceptions discussed hereinafter which are necessary for emphasis of appellee's position rather than for correction of appellant's statement. The statement of facts appearing

in appellant's summary of argument is less accurate and we do not accept it. For instance, at the foot of page 13 appellant states that receipts from sales made by the San Francisco house in other states are credited to the San Francisco house's credit. The record does not support this statement; on the contrary the record does not suggest that the San Francisco house makes any sales in other States. Also, the statement in the first sentence of the first paragraph commencing on page 15 of appellant's brief, that appellant's entire net income was $1,149,677 "after taking into consideration the loss at San Francisco of $82,851" is not found in the record. The statement is appellant's creation, based on inferences drawn by appellant from the record and denied by appellee.

The stipulation of facts does not state that appellant operated at a loss in California, and appellee's contention is that the evidentiary facts stated in the stipulation do not establish that appellant did not derive the net income from California which the allocation formula attributed to California. The stipulation of facts further shows that appellant's business was a unitary business. (These statements are elaborated later, when the page numbers of the supporting part of the record will be given.)

Thus appellee contends that as appellant was conducting a unitary business within and without California, appellee was entitled to use a reasonable formula in allocating appellant's income. (The

formula used is specified to be a reasonable formula. Record, page 10, paragraph 7.) Appellee further contends that the formula method of allocation is best suited to produce a proper allocation of income, and that the allocation by separate accounting, which appellant offers as proof that the formula reached an unreasonable result, is itself not capable of producing a proper allocation and therefore is not an acceptable gauge to test the reasonableness of the formula allocation.

In other words, appellee contends that the Constitution of the United States does not compel him, as tax administrator, to accept appellant's separate accounting allocation as accurate and as conclusive evidence that the formula allocation has produced an unconstitutional result.

SUMMARY OF ARGUMENT

Appellee will show that the method of allocation offered by appellant as evidence that the use of the formula reached an unconstitutional result is itself incapable of reaching a correct result, and therefore is not evidence which is entitled to credence. We will also show its similarity to methods of allocation which other taxpayers have unsuccessfully offered to this Court as evidence that they have been subjected to unconstitutional exactions. We will show that the formula method of allocation is best suited properly to allocate the income of a unitary business, such as appellant's, and that it reaches

a more accurate result than the separate accounting method used by appellant. We also will show that the formula method is the only practicable method of allocation for the States to use in the case of a unitary business.

As appellant has attempted to construe the stipulation of facts as entitling appellant to as many new trials as may be necessary for appellant to prevail, and as prohibiting the drawing of any inferences unfavorable to appellant, we will also show that appellant's construction of the stipulation is insupportable.

THE STIPULATION OF FACTS

Because we believe that appellant is seeking to give an interpretation to the stipulation of facts, and particularly to certain portions of it, which differs from the intention of the parties, we believe it necessary that space be devoted to an analysis of the stipulation itself.

First, it should be observed that no express stipulation is made that the amount of local expenses was correctly shown in the local books, or even that the cost of the goods sold in California was correctly shown therein. Paragraphs 2 and 3 of the stipulation (Record, p. 8) state that entries for these charges were made in the local accounts, but no agreement is stated that these entries were correct. Paragraph 5 (R-9) states that these charges were deducted on appellant's books in the computation therein of the results of the California opera-

tions, but again there is no statement as to the accuracy of these entries. The inference may be drawn from paragraphs 10 (R-11) and 13 (R-12) that appellee merely disputes that separate accounting produces a correct allocation and that appellee does not dispute that the entries are correct if the basic assumption on which they are founded is correct; namely, that separate accounting allocation can be correct in the case of a unitary business. We have heretofore drawn this inference, and so did the California Supreme Court, for so the parties intended, but if appellant is correct that paragraph 12 (R-11, 12) of the stipulation prohibits the drawing of inferences, then we have improperly drawn this inference. In that event for all that the record shows the books may be hopelessly inaccurate on any theory and therefore appellant has not taken even the first step to prove its case.

Secondly, the stipulation does not state that appellant had a loss from its California business and appellee has throughout the case consistently denied that appellant did. The stipulated facts relate only to the manner in which appellant operated, what its local books showed, how the computation in those books was made, what appellant's entire net income was and how appellee's computation was made. To decide the case from those facts the California Supreme Court had to draw either of two inferences: (1) that there was a loss; (2) that

no loss was shown. Appellant has objected violently to the action of the California Supreme Court in drawing the latter inference, and has claimed that no inferences at all can be drawn in view of paragraph 12 of the stipulation, yet appellant's only hope of prevailing has been to persuade the courts to draw the former inference.

The foregoing discussion establishes either that appellant has stipulated itself out of court or that appellant's interpretation of the stipulation is insupportable. The latter alternative appeals to us. The sole purpose of the stipulation regarding inferences and presumptions was to avoid a decision resting entirely on presumption of official regularity. The stipulation was not intended to shift the burden of proof which appellant bore, as plaintiff, to appellee, the defendant. This, we submit, should be obvious. As plaintiff, appellant had to establish error in the use of the allocation formula. The issue in the case is whether this was established. The law of California is that it was not, and unless that law offends the Constitution appellant can not prevail.

Appellant has also objected to the action of the California court in stating that the central advertising division, central accounting and central executives indicate a unitary system. Appellant's objection is on the ground that the record does not specifically so state. However, the record does show that appellant itself considered that those

central divisions were made possible by the maintenance of the several stores and benefited them alike, for it allocated some of the expense of maintaining such divisions to each store, which appellee stipulated was correct. (R-9, para. 4) Thus the record supports the action of the California court.

Hereafter a section of our brief is devoted to a discussion of the second portion of paragraph 12 of the stipulation, agreeing to the reopening of the case for further facts if insufficient facts for a decision are contained in the stipulation. For that reason, no discussion of that portion of the stipulation is made at this point.

ARGUMENT

I. The tax on appellant has been measured by income derived from business done in California and not by income derived from business done in other States

A. In the case of a unitary business carried on within and without a State, the income derived from the business done in any State may more accurately be determined by an allocation formula than by separate accounting

There are in general two distinct methods, the separate accounting method and the formula method, commonly used for determining the income for income or franchise tax purposes from business carried on within a particular State, in the case of taxpayers engaged in business both within and without the State. Under the separate accounting

method, as the name implies, the business within the State is treated as though it were separate and distinct from the business carried on outside the State. An attempt is made to determine the net income from the particular State in the same manner that it would be if the business were confined to that State; an effort is made to determine the gross income from that State, and the expenses attributable to it are separately determined as closely as possible, and the latter figure is deducted from the former figure.

Where business is carried on both within and without the State, this method requires the segregation of the gross income and expenses attributable to the State from the total gross income and expenses. Where the business within the State is truly separate and distinct from the business without the State this segregation can be made fairly, easily and accurately, and, accordingly, the separate accounting method may properly be used. Where, however, the business within the State is not a separate business but is an integral part of a unitary business carried on within and without the State, difficulties will be encountered both in the segregation of the gross income attributable to the State and in the segregation of the expenses attributable thereto. Suppose, for example, that a particular company is engaged in the manufacture of goods in State A and the sale of such goods in State B. Goods costing $100,000 to manufacture

are sold for a total of $150,000. The company thus has a gross income, i.e., difference between cost and selling price, of $50,000. Before the net income from the business carried on in either State can be determined under the separate accounting method, it is necessary to determine what portion of the gross income is attributable to each State. One separate accounting method which taxpayers frequently contend should be used for making such apportionment is to determine a reasonable manufacturing profit which becomes the gross income for the State of manufacture and is added to the cost of the goods for the purpose of determining the gross income attributable to the State where the goods are sold. Thus, in the instant example, if a reasonable manufacturing profit were determined to be 10 per cent of the cost, the gross income attributable to State A would be $10,000. The cost of the goods manufactured and sold would be increased from the actual cost of $100,000 to $110,000 for the purpose of determining the gross income in State B, which as so determined would be $40,000.

The principal objection to the above method of apportioning the gross income is that any such determination of manufacturing profit is apt to be arbitrary, representing merely the opinion of the taxpayer, which may be biased, particularly if one State imposes an income tax or a tax measured by income and the other does not.

Any attempt to reach an objective standard for determining a reasonable manufacturing profit, based on the experience of other manufacturers, is not likely to prove successful. In the first place, it is probable that in the great majority of cases it will be impossible to find a sufficient number of manufacturers engaged in the production of the same goods, on the same scale and under similar conditions as in the case of the company in question, to be of any value for comparison purposes. But even if a sufficient number of such other manufacturers could be found, if they sell their goods in the same manner as the company in question, no assistance will be obtained from their experience since the identical problem of arriving at a manufacturing profit will exist in their case as well. Then too, if they sell their products in a different manner, at wholesale, for instance, whereas the company in question sells at retail, not only will there still be the problem of apportioning their income between manufacturing and selling activities for the purpose of arriving at a manufacturing profit but their experience will be of little help for comparison purposes. The most that their experience would tend to establish is what income the company in question might have made if it had sold its product in the same manner as such other manufacturers rather than in the manner in which it actually sold them. The problem, however, is to

determine how the income from a particular business conducted in a particular manner should be apportioned. A determination of this problem can not be made on the basis of conjecture as to what the results of operation would have been if the business had been operated differently.

Another method which taxpayers using the separate accounting method for allocating income of unitary businesses employ in segregating the gross income is to determine what the company in question would have paid for the goods it sold if it had bought the goods from independent manufacturers rather than manufactured them itself. This cost so determined is used in place of the actual cost, and the gross income is apportioned accordingly.[1] Thus, in the preceding example, it might be determined that the company would have had to pay $120,000 for the goods which it manufactured at a cost of $100,000 if it had not operated its own manufacturing plant, but instead had purchased the goods from other manufacturers. The gross income attributable to State A, the State of manufacture, would thus be fixed at $20,000. In arriving

[1] This was the method approved in *Standard Oil Co.* v. *Wis. Tax Comm.*, 197 Wis. 630, 223 N.W. 85, in which the Wisconsin court overlooked the fact that limiting the selling division's gross profit to the excess of the retail price over the wholesale price to independent purchasers had the effect of reducing the selling division's income in exact ratio to the increase in that division's effectiveness, for both the wholesale price and the fictitious market value are largely dependent on the effectiveness of the selling division. Other faults in the separate accounting approved in that case are that (1) it failed to allocate any gross income to Wisconsin from the maintenance there of tank farms for the storage of oil sold in other states but it did allocate to Wisconsin all of the expense of operating those farms, and (2) it allocated a portion of the central overhead expenses to Wisconsin but none of the central income.

at the gross income attributable to State B, $120,000 would be taken as the cost. Since the goods were sold for $150,000 the gross income attributable to State B would amount to $30,000. The theory underlying this method is that if the company had purchased its goods instead of manufacturing them itself, it would have had a gross income only in the amount of the difference between the purchase price and the sale price. Hence, under this theory, any additional gross income which it receives must be due to its manufacturing activity whereby it was enabled to save the difference between the actual cost of the goods and the price it would have had to pay if it had purchased such goods. The theory is fallacious. It is based on sheer conjecture as to what would have happened had the corporation confined its activities entirely to selling, which it did not do. One could as fairly indulge in conjecture as to the consequences if the corporation had not possessed its selling organization but had confined its activities entirely to manufacturing. In that case the corporation might not have been able to sell its goods at all, or at best might have been unable to sell them for more than the cost of manufacturing. That being possible, it must be that the entire net income is derived from or attributable to the selling activities. This conjecture is as reasonable as the one based on a supposed nonexistence of manufacturing activities, yet it reaches the opposite result. Both theories can-

not be right. Actually neither one is since each ignores the fact that the business is one unitary business consisting of two interdependent activities, both of which contributed to the earning of income.

Under any method of apportioning gross income, and as indicated above, such an apportionment is essential to the use of the separate accounting method, it may frequently happen that losses will be reported in some States whereas the company realizes net income from its entire business, and, in other cases, net income will be reported in some States whereas the entire business is operated at a loss.

Thus, suppose that in the preceding example the selling expenses amounted to $40,000. The company would accordingly realize a net income of $10,000 ($150,000 gross receipts less $100,000 cost of manufacture and $40,000 selling expenses). Under the separate accounting method, however, if the cost of the goods sold were assumed to be $120,000 for the purpose of apportioning gross income, the company would report a net income in State A of $20,000 ($120,000 minus $100,000, the actual cost of manufacture) and a loss in State B of $10,000 ($150,000 gross receipts minus $120,000, assumed cost=$30,000 gross income minus $40,000 selling expense=$10,000 loss). To show a loss in State B whereas without the activities therein the company might not have income at all, and to show a net income of $20,000 in State A whereas

the actual net income from the entire business is but $10,000 is clearly erroneous.

If in this example, the selling expenses had amounted to $60,000, the company would have had an actual loss of $10,000 ($150,000 gross receipts less $100,000 cost of manufacture, and $60,000 selling expenses). Under the separate accounting method, however, the conclusion would still be reached that the company realized a net income of $20,000 in State A, the State of manufacture. This conclusion is plainly absurd. It is no answer to point out that if it were not for the manufacturing activities, whereby the company obtained goods at a cost of $100,000 which it would otherwise have had to purchase at a cost of $120,000, the company would have had a $20,000 greater loss, and to argue therefrom that the manufacturing activities should be credited with an income of $20,000, the amount of the additional loss avoided. The fact is that the company is not engaged solely in the business of selling goods, but is engaged in the business of manufacturing and selling which sustained an actual loss of $10,000. To tax it on or measured by net income in any amount, under such circumstances, is to tax it on or measured by something that does not exist.

Even if some adequate and reasonable method of apportioning gross income in the case of a unitary business could be found, insurmountable difficulties would still be encountered in apportioning the ex-

penses and other deductible items among the various States in which the business is conducted. Such expenses and other deductible items are frequently apportioned by assigning to each State in which the business is conducted, the expenses directly incurred therein, such as rental for, and taxes and depreciation on property located there, and compensation for services performed there. Certain indirect or so-called central expenses, such as officers' salaries, advertising expense, and interest on money borrowed, which admittedly are not incurred wholly on account of the business carried on in any one State, are apportioned among all the States in proportion to gross receipts or gross sales or by some other formula. Although this method of apportioning direct expenses between States may be proper where the business in each State is separate and distinct from the business carried on in other States, where the business is a unitary business it is definitely inadequate and unsatisfactory. In the case of such a business, the place where expenses happen to be incurred has little or no bearing on the question of how such expenses should be allocated. This proposition is recognized in separate accounting in so far as the so-called central expenses are concerned, but it is denied when expenses locally incurred are concerned. It is, however, equally correct for both types of expense. In the case of a business consisting of the

manufacture and sale of goods, for instance, the incurring of selling expenses in a particular State may have a very definite bearing on the amount of income realized from sales in other States. The incurring of such expenses may result in greater sales. An increase in sales in turn requires an increase in production. An increase in production will result in a reduced per unit cost, resulting from spreading certain fixed or more or less constant charges, such as depreciation and taxes on the manufacturing plant, over a greater number of units, from increased purchasing power with a consequent reduction of cost per unit of raw material, or from a combination of these or other means. A decrease in the unit cost of goods manufactured, will in turn result in an increase in the profit or income realized from sales made in other States. The expenses incurred therefor have a direct bearing on the business as a whole, and should not be charged entirely against the gross income arbitrarily assigned to the State where incurred.

This method of apportioning so-called direct charges to the States where incurred is so arbitrary and ill-suited to the proper apportionment of income that it is possible that under this method the selling activities within a particular State may show either no income or a loss even though the entire gross income from sales made therein were apportioned thereto and even though the company incurring such expenses made a greater income

than it would otherwise have made. This point may be illustrated by the following example: A particular company is engaged in the manufacture and sale of products in State X. It manufactures 100,000 units at a cost of $100,000 which it sells for $125,000. The selling expenses amount to $20,000. The company thus has a net income of $5,000. The company decides to open a sales office in State Y. Through the efforts of this office additional sales of 100,000 units are made resulting in additional receipts of $125,000. Although the sales and consequently the units produced are doubled, the additional manufacturing costs amount to but $50,000 resulting in a per unit cost of 75 cents for 200,000 units in place of a per unit cost of $1 for 100,000 units as formerly. In order to increase its sales by 100,000 units, however, it was necessary to carry on an extensive selling campaign in State Y. Furthermore, rents, salaries and other expenses in State Y are proportionately higher than in State X. Thus the sales expenses incurred in State Y amount to $50,000 as compared to $20,000 in State X. Notwithstanding this relatively high selling expense, the company makes $30,000 net income ($250,000 gross receipts less $150,000 cost of manufacture, and less $70,000 selling expense of which $20,000 was incurred in State X and $50,000 in State Y), or $25,000 more income as a result of doing business in both States X and Y than it made when its business was confined to State X. Al-

though it would not be proper to assign the entire additional income to State Y, since it could not have been made without the manufacturing plant and sales in State X, certainly some portion of the income should be assigned to State Y; yet under the separate accounting method whereby so-called direct expenses incurred within a State are apportioned entirely to that State, no net income will be attributed to State Y, even though the entire gross income from the sales made therein are apportioned to that State. The gross income from sales made in State Y is $50,000; i. e., $125,000 gross receipts less $75,000 cost of goods sold (100,000 units x 75 cents, the per unit cost). If the direct expenses of $50,000 incurred in State Y are deducted, the answer is zero or no net income assigned to State Y.

If in this example the selling expenses incurred in State Y amounted to $60,000, the conclusion would be reached under the separate accounting method that the company operated at a loss of $10,000 in that State, notwithstanding the fact that the company made $20,000 from its entire business or $15,000 more by doing business in both States than it would have made if it had done business only in State X.

These results are clearly distorted. It can readily be appreciated that the results would be even more greatly distorted if a portion only of the gross income from the sales made in State Y were

assigned thereto and if in addition to the expenses in State Y a portion of the indirect or so-called central expenses were attributed to that State.

The foregoing examples are equally applicable to the case of a corporation engaging in the business of purchasing and selling goods in several States. Suppose that a company is engaged in the purchase and sale of goods in State A. It purchases 1,000,000 units at a per unit cost of $1, a total purchase price of $1,000,000. The goods are sold for $1,250,000. The selling expenses amount to $200,000. Its net income is thus $50,000. By doubling its purchases, the company is able to obtain lower prices and is thus able to buy 2,000,000 units at a total cost of $1,500,000, or at a per unit cost of 75 cents. It is able to double its purchases and thus obtain the reduced prices only by doubling its sales. To do this it is necessary to open a sales office in State B and to maintain an extensive sales organization therein. For various reasons the sales expenses in State B are unusually large and amount to a total of $600,000. The company nevertheless increases its profits from $50,000 to $200,000. ($2,500,000 gross receipts less $1,500,000 cost of goods sold and $800,000 selling expense, of which $200,000 was incurred in State A and $600,000 in State B.) Notwithstanding the fact that by virtue of the sales in State B the company made an additional income of $150,000, under the separate accounting method the conclusion would be reached that the activities

in State B resulted in a loss of $100,000. ($1,250,000 gross receipts from sales in State B minus $750,000 cost of goods sold=$500,000 gross income; deducting the $600,000 sales expense incurred in State B results in a loss of $100,000.)

In the same manner as in the above example, so in the instant case, the conclusion would be reached under the separate accounting method that appellant's sales activities in a number of States were operated at a loss, notwithstanding the fact that the appellant's business as a whole made income which could not have been made were it not for its ability to purchase in large quantities which in turn was made possible by virtue of the sales activities in the various States in which appellant does business.

Separate accounting also fails in other ways to reflect accurately the net income properly attributable to each State in which a buying and selling business operates. For instance, suppose X Corporation, a wholesale house which buys and sells general merchandise in State A, has overhead or central expenses of $100,000, consisting of officers' salaries, advertising costs, accounting expenses and similar expenses. In 1934 X Corporation sold 1,000,000 units in State A at $1 each for a profit of $10,000 ($1,000,000 gross receipts less $690,000 cost of goods sold less ~~$200,000~~ $200,000 direct selling expenses, less $100,000 central or overhead expenses=$10,000). But in 1935 X Corporation

moves into State B and in addition to its sales in State A sells 500,000 units in State B, making a total of 1,500,000 units sold in the two States. The excursion into State B did not result in a lower per unit cost for the goods sold and the per unit selling expenses in State B were higher than in State A. However, operations in State B only increased the overhead or central expenses by $20,000 to a total of $120,000. Thus as a result of the excursion into State B the corporation made a net income of $20,000 ($1,500,000 gross receipts less $1,035,000 cost of goods sold [$690,000 plus $345,000 equals $1,035,000] less $325,000 direct selling expenses less $120,000 central or overhead expenses=$20,000) or $10,000 more than the corporation had made when it sold only in State A. As the corporation made a greater income because it operated in State B obviously some of its net income is derived from State B. Under the separate accounting system of allocation, however, no income at all but a loss would be assigned to State B. ($500,000 gross income less $345,000 cost of goods sold less $125,000 direct selling expenses less $40,000 central or overhead expenses equals a $10,000 loss). The reason for the inaccuracy of separate accounting in this example is two-fold: one, it charges the entire direct expenses of selling to the State where those expenses are incurred (the fallacy of this has been discussed earlier); two, it assigns the central or overhead expenses to each

State on an arbitrary per-unit basis[1] instead of on a basis of actual experience. One reason the latter is done is because it is usually impossible to trace the cause of increased central expenses from one State to another. However, the impossibility of tracing this cause does not support the conclusion that increased central expenses *must* be charged against each sale or each State on a *percentage* basis. Instead, that conclusion is supportable only on either of two possible grounds; one, the desperate impossibility of a more accurate method; or, two, the assumption that an average or norm prevails throughout the States in which the business is done, which justifies assigning the central expenses on an average or formula basis. If the first of these grounds is the prevailing one, it is an admission of fallibility in the separate accounting system which prevents its being used as a gauge by which to test the accuracy of any other allocation system. If the second of these grounds is the prevailing one, it provokes the query of why the average or formula system should not be used to allocate all other items as well as central expenses, for if the

[1] This method of allocating central expenses was used in the separate accounting of Butler Brothers. 75% of the central expenses allocated to and charged against the California house would have been incurred even though the California house had not operated. (Stipulation of Facts, Para. 4. Record, p. 9.)

average is correct for any item it should be for all.[1]

In summation, a very simple example will serve to illustrate the inaccuracy of the premise on which separate accounting rests and of the results which it produces. Suppose Mr. X has in Tennessee a potential customer who will pay $100 for a horse. X finds that such a horse as this Tennessee customer wants will cost X $100, including transportation costs, so if X bought such a horse and sold it in Tennessee, he would not have any net income. However, X finds that while he must pay $100 for one horse he can buy two identical horses for $150, including transportation costs. But if X buys two horses for $150 and sells only one he will lose on the transaction even if he sells that one horse for $100. Then, however, X finds a customer in California who will pay him $75 for the second horse. The second sale will enable X to realize $175 from the transaction, or a gain of $25. So X sells one horse in Tennessee for $100 and the other in California for $75, thus getting a net income of $25. Under the separate accounting

[1] Accepting the propriety of using a formula to allocate some of the expenses, but attacking the propriety of using a formula to allocate other expenses and the gross income, is an inconsistency which vitiates the attack on the formula. *Norfolk & Western Ry. Co.* v. *Maxwell*, 297 U. S. 682.

Appellant has suggested that there is no issue between us regarding the propriety and accuracy of its allocation of central expenses. Appellant's understanding is not altogether correct. Inasmuch as we contend that a formula should be used to allocate appellant's net income, including therein its gross income and expenses, we naturally agree that the allocation of the central expenses by a formula is correct, and we so stipulated. We did not, however, stipulate or agree that the use of formula allocation of central expenses in conjuction with the direct allocation of other expenses and gross income was correct or proper, or tended to produce an accurate result.

method of allocation, X's entire gain would be allocated to Tennessee, because the horses were purchased for an average cost of $75 apiece and the only one which was sold for more than that was the horse which was sold in Tennessee. It would be fully as reasonable, however, to assign the entire income to California, because actually the first horse cost X $100 and the second one cost him $50, and the only horse which was sold for more than its cost price was the one sold in California. Actually neither solution is correct. Both sales were absolutely necessary steps in deriving the net income from the transaction, and the income is attributable to the two together, not to either one alone. Therefore, when the necessity arises of allocating the net income between the States in which the sales took place, each State must be credited with some of the net income. This may be done only by the use of a formula.

For the above reasons the conclusion is inescapable, as the California Supreme Court held, that the separate accounting method is wholly unsuited to the proper apportionment of the income of a unitary business. It is believed that the only proper method for making the apportionment is to employ a formula which gives weight to the various factors responsible for the earning of income, such as (1) *property*, which reflects the capital investment, (2) *pay roll*, which indicates the value to the taxpayer of the services of its employees, and

(3) *sales,* which give weight to the activity of the taxpayer in obtaining customers without which, of course, the business would not function.

Under the formula method the entire net income from the entire business is first determined by deducting from its entire gross income the total expenses and other deductible items. After this is determined income *unconnected* with the unitary business, such as gains from the sale of capital assets, interest on bonds, dividends on stock and other income from intangibles, which may be apportioned according to the location or situs of the property or otherwise, is excluded or deducted from the entire net income. The remainder of the income, constituting the net income from the unitary business, is apportioned among all the States in which business is conducted on the basis which the average of the factors of the formula within the State bears to the average of the total of such factors within and without the State.

This method is simple of application, and avoids the uncertainties, guesswork and conjecture incident to the separate accounting method. Furthermore, under this method income will not be attributed to any State unless the entire business of which the business within the State is an integral portion is operated at a profit. Likewise, losses will not be attributed to any State unless the entire business sustains a loss.

B. The business carried on by appellant is a unitary business

Appellant is engaged in the wholesale dry goods and general merchandise business. (R-8) Appellant buys goods through a central purchasing division and sells those goods through seven stores or houses, one of which is located in San Francisco, California. (R-8) Being wholesale stores, these stores sell exclusively to the retail trade. (Page 14, appellant's brief.) Thus appellant's business could not exist profitably unless appellant could buy the goods it sells more cheaply than the retailers to whom it sells could buy them elsewhere. Therefore appellant's ability to buy its goods at a low price is the primary cause of appellant's earning a net income in 1935 of $1,149,677.

The stipulated fact is that appellant is able to buy at lower prices because of the greater volume of purchases which it makes than it could if it were buying only for one of its stores. (R-10, para. 8) As the California Supreme Court pointed out, appellant is able to purchase in such volume only because it can sell in such volume. Thus the purchasing differential is made possible by the great volume of sales appellant makes, to which the California store adds. Thus the California store is a factor in enabling appellant to buy at reduced prices; i. e., to make a purchasing saving. Furthermore, the saving is not turned into profit until the sales are made. Thus, the purchasing activities

and the sales activities are interdependent and supplement one another to form one single, unitary business.

Appellant has attempted to draw the inference that the California house is not a factor in making possible this purchasing saving, by emphasizing the admitted fact that the addition to or deduction from the total purchases of an amount *equal to* the purchases made for the San Francisco store would not affect the purchasing differential. Appellant attempts to construe this fact as meaning that the California store did not contribute to the purchasing saving. Such a construction is erroneous, for as much reason exists for charging any of appellant's other stores with failure to contribute to the purchasing saving, to the extent of purchases in that amount, as exists for charging the California house with such failure.

The stipulation does not state that if the San Francisco house were eliminated the purchasing differential would not be affected, nor does it state that the purchases made for the San Francisco house could be eliminated without affecting the purchasing differential. It states that the addition or deduction of an amount of purchases "equal to" the purchases made for the San Francisco house "would result in no less favorable prices being obtainable in respect of the purchases which would be made for the remaining houses of the Company." (R-10, 11, para. 9.) It is important

to observe that the stipulation refers to an amount of purchases *equal to* those made for the account of the San Francisco house. From paragraph 8 of the stipulation (R10) it appears that about $5,000,000 of purchases were made for the account of the San Francisco house. Thus all that the stipulation says and means is that the addition or subtraction of $5,000,000 of purchases would not affect the purchasing differential. That particular $5,000,000 of purchases is not tied up with the San Francisco house except that the latter is used as a measuring stick. The $5,000,000 of purchases may be those made for any house. It is economically impossible to select one house and charge it with responsibility for those purchases. They may as reasonably be the purchases of any one house as of any other. If appellant could successfully charge the California house with failure to cause the price differential, appellant could then proceed in turn to each of its other houses and successfully charge each of them with the failure. The result would be that all of the houses would be charged with failure to cause the price differential, whereas the stipulated fact is that they did cause it.[1]

A simple illustration will demonstrate why the California house can not be singled out as not contributing to the purchasing saving. Suppose seven metal blocks weighing 25 pounds apiece were laid

[1] If any one house must be charged with failure to cause the price differential, that house should be the Baltimore house, which was acquired last and joined the unitary group after the price differential had probably been achieved. (R-8, para. 1)

side by side on scales capable of registering only 150 pounds. Any one of those blocks, which total 175 pounds in weight, can be removed from the scales without causing the scales to register less than their 150 pound maximum. Remove them all and the scales will register zero. Which metal block is exclusively superfluous? Any block one wishes to select can be removed without changing the weight registered by the scales, but return it to its place on the scales and remove its neighbor. The result is the same; the scales are still tipped at 150 pounds. Thus it is apparent that each block is contributing to the same extent to keeping the scales tipped at 150 pounds and no one block can be accurately selected as the one block which is unnecessary. So it is with attempting to select one of appellant's seven houses and charge it exclusively with failure to cause a purchasing saving.

The centralized purchasing is a factor which makes appellant's business a unitary business. As the examples in the preceding section of this brief demonstrate, separate accounting does not accurately allocate the income of a buying and selling business with centralized purchasing, and the use of a formula is necessary.

Other facts characterizing appellant's business as unitary are appellant's central executives, a central advertising division, and central accounting. (R-9, para. 4)

The business of buying and selling in several States under conditions like those in this case has been held to be unitary in *Great Atlantic & Pacific Tea Co.* v. *Grosjean,* 301 U. S. 412, and in *International Elevator Co.* v. *Thoresen,* 58 N. Dak. 776, 228 N. W. 192. In the *Great Atlantic & Pacific Tea Co.* case the determination that an integrated buying and selling business was unitary led to a decision that a state chain store tax was valid although it was graduated according to the total number of stores in the chain, including out-of-state stores. In the *International Elevator Co.* case the determination that such a business was unitary led to a decision that a formula should be used to allocate its net income, instead of separate accounting.

Likewise the decisions in *Underwood Typewriter Co.* v. *Chamberlain,* 254 U. S. 113, *Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Comm.,* 266 U. S. 271, and *North American Cement Corp.* v. *Graves,* 299 U. S. 517, support the conclusion that appellant's is a unitary business. In these cases this Court held that the business of manufacturing and selling was unitary, emphasis being laid on the fact that a corporation which manufactures goods for sale must sell them to derive income. As it is fully as true that a corporation which buys goods for sale must sell them to derive income, it follows from these cases that a buying and selling business conducted in several states is a unitary business.

As appellant's business is a unitary business, separate accounting is, for the reasons explored in the preceding division of this brief, inadequate to the task of allocating the net income between the respective States, and a formula must be used for that purpose.

C. This Court has already recognized that separate accounting does not correctly allocate the income of a unitary business and is insufficient evidence to establish that a formula has reached an unreasonable result

In at least two cases before this Court, an allocation by separate accounting was offered by the taxpayer as evidence that formula allocation had reached an erroneous or unreasonable result.

The first of these cases was *Underwood Typewriter Co.* v. *Chamberlain*, 254 U. S. 113. To overthrow the State's formula allocation, the taxpayer offered an elaborate separate accounting allocation showing the gross receipts realized in Connecticut and those realized in other States, the expenses incurred in each State, and the amount by which the gross receipts from Connecticut exceeded the expenses incurred in that State. The result was claimed by the taxpayer to be the net income derived from Connecticut, and in a completely physical sense the taxpayer was right. Had each dollar of gross receipts been traced to the State in which the taxpayer had first acquired that dollar, and the appropriate deductions been taken

from it, the net result would have coincided with the taxpayer's allocation. This Court, however, recognized that the place of realization of gross receipts is not necessarily the place from which all the net income resulting from that realization is derived. Accordingly the Court held that the taxpayer's separate accounting allocation, which failed utterly to give weight to the income producing potentialities of the manufacturing process in Connecticut, was not sufficiently accurate an allocation to overthrow the presumption that the formula allocation was accurate. It is significant that the separate accounting allocation offered by the taxpayer in the *Underwood Typewriter* case is the same in general plan as that offered by appellant herein. It is also interesting, in view of appellant's discussion of the use of inferences by the California Supreme Court, to note that on page 19 of the brief of defendant in error in the *Underwood* case the State contended that the taxpayer's case was built upon "assumptions, inferences, assertions and hypotheses."

The other case is *North American Cement Corp.* v. *Graves,* 299 U. S. 517. This memorandum decision affirmed the New York Court of Appeals, which had affirmed without opinion a lower court which had also not written an opinion. Thus the facts of this case must be taken from the record, which shows that the taxpayer offered an elaborate

separate accounting allocation in an effort to overthrow the State's formula allocation. The taxpayer in this case operated two cement plants in New York, one in Maryland and a lime plant in West Virginia. According to the only evidence on the point in the record, (Page 75, Record, in the *North American Cement* case) the four plants were separately operated, separate accounts were kept for each, and very little output of the West Virginia and Maryland plants was sold in New York. The taxpayer's separate accounting allocated a small income to New York for 1925 and large losses for 1926, 1927 and 1929. The State's formula allocated large incomes to New York for each of those years. The separate accounting allocation (a representative example of this allocation may be found in the Appendix herein) was prepared by a distinguished accounting firm and certified by that firm to be accurate. The separate accounting first allocated net income (or a loss) to New York and then broke that figure down into the portion attributable to each of the New York plants. It is manifest that had the separate accounting in this case been deemed credible, the formula would have been shown to have operated unfairly against the taxpayer, but the formula allocation was upheld.

On page 39 of its brief appellant suggests that the separate accounting allocation in the *North American Cement* case was entitled to less weight than appellant's separate accounting allocation,

because appellant's is used for some purpose in addition to use for tax purposes, whereas the separate accounting allocation in the *North American Cement* case was used only for tax purposes. We cannot see how the conclusion reached by appellant would follow even if the facts were as appellant claims, for those facts have no bearing on the accuracy of the separate accounting allocation. However, the record herein fails to establish that the allocation made in appellant's local books was designed or used for any purpose other than tax purposes. On the other hand the separate accounting allocation in the *North American* case was required to be made by the terms of a bond issue (see p. 39 of the record in that case) and was used for that purpose as well as for tax purposes. As the separate accounting allocation in the *North American Cement* case was actually more detailed than that offered by appellant, we cannot see any reason for assuming appellant's to be more accurate than that in the *North American Cement* case.

Separate accounting allocation was also offered by the taxpayer in *Bass, Ratcliff & Gretton* v. *State Tax Comm.*, 266 U. S. 271, and was held insufficient to overthrow the formula allocation. However, the taxpayer's separate accounting allocation merely showed a loss from its United States business, 93% of which was transacted in New York. The Court's decision may have rested on the ground that showing a loss from the United States

did not prove that a loss had been suffered in New York, instead of on the ground of the general inappropriateness of separate accounting to the task. The Court's opinion, however, suggests that the latter was the ground chosen.

The decision in *Hans Rees' Sons* v. *North Carolina*, 283 U. S. 123, did not approve allocation by separate accounting.[1] What this Court held in the *Hans Rees* case was that where evidence was offered which showed without challenge that the formula allocated a much larger income to the taxing State than was fairly attributable to the business done within it, the particular formula allocation was not proper. The decision in that case left open the question of the type of evidence which would be accepted as proof of the inaccuracy of a formula allocation, because the State in the *Hans Rees* case at no time questioned the fact that the evidence did show that the formula allocated to the taxing State more income than was actually attributable to the business done within it.

A review of the record in the *Hans Rees* case is essential to a proper discussion of that case, as many important facts do not appear in the opinion. The record showed that whereas the State's formula allocated net income on the basis of the ratio of property owned in North Carolina to property owned everywhere, the taxpayer had a factory on

[1] The effect of this decision has been the subject of a critical discussion in "Interstate Allocation of Corporate Income," 40 Yale Law Journal 1273, 1 *Selected Essays on Constitutional Law*, V 272.

leased premises in New York. The particular allocation formula used did not allocate any of the taxpayer's net income to New York on account of that factory, yet a proper formula would not have ignored the fact that there was as much reason for the New York factory to be productive of some income as for the North Carolina factory to be. Furthermore, the inaccuracy of the particular formula used in that case was enhanced by the fact that Hans Rees' Sons had timber reserves in North Carolina (bark was used in their tanning operations). These reserves were not actively used in the production of income, yet some income was allocated to North Carolina on their account but none was allocated to New York on account of the factory in that State. Thus the formula in the *Hans Rees* case allocated over 80% of the net income to one factory and none to the other factory, obviously an unreasonable result. Even accepting North Carolina's assumption that most of the income was attributable to the manufacturing function, that would not justify attributing all the manufacturing income to the North Carolina factory to the exclusion of the New York factory. This fact must have influenced the final decision, as witnessed by the several references in the Court's opinion to the impropriety of allocating nearly the entire net income to North Carolina.

For evidence to prove that it was unjustly treated, Hans Rees' Sons did not offer a mere

separate accounting allocation. Instead, Hans Rees' Sons offered elaborate analyses of the causes of its profits. One line of evidence tended to show that the corporation's entire manufacturing activities were conducted at a loss in three of the four years involved. Another line of evidence tended to show that the entire manufacturing activities produced no profit in 1926, and 26%, 13% and 37% of the profit in the other three years, an average of 17%. Even assigning this entire profit to North Carolina and none to the factory in New York, still the income allocated to North Carolina by the formula was greatly in excess of the manufacturing profit.

North Carolina did not question that the evidence which was offered proved that the income actually attributable to North Carolina was far less than that which the formula allocated to that State. The North Carolina Supreme Court did not question it either, but held that the evidence was not material since the formula was not inherently arbitrary.

This Court did not hold that a formula was improper in the *Hans Rees* case. This Court merely held that a formula would not be sustained which allocated to the taxing State "a percentage of income out of all appropriate proportion to the business" transacted in that State. As the formula in the instant case consists of property, payroll and sales, the income allocated to California is in exact

proportion to the business done in California. This, we submit, is all that the *Hans Rees* case requires. Furthermore, even if that decision is authority that a loss can be attributed to one of the States in which a unitary business is conducted whereas the entire business is done at a substantial profit, the *Hans Rees* case does not support the view that separate accounting allocation is competent to establish the existence of that loss. As other decisions of this Court [1] are to the contrary, we submit that this Court has already recognized that separate accounting allocation is in–appropriate in the case of a unitary business.

D. Appellant has not shown that the formula does not accurately apportion its net income

The burden is upon appellant in attacking the formula

> "to make oppression manifest by clear, cogent evidence."—*Norfolk & Western Ry. Co.* v. *Maxwell,* 297 U. S. 682, 688.

We submit that appellant has not done this.

As this Court observed in the *Norfolk & Western* case,

> "What the formula does assume is this, that barring exceptional conditions there will be

[1] The most recent decision of this Court involving formula allocation, *Ford Motor Co.* v. *Beauchamp,* 308 U. S. 331, is a sweeping approval of the right of the States to use formula allocation. Although the tax in that case was measured by capital employed in the State rather than by net income, the decision affords support to appellee's position herein since the taxpayer, relying on the *Hans Rees* case, unsuccessfully offered a breakdown of property employed in the State which was analogous to separate accounting allocation of income.

throughout the system such an average relation between revenues and expenses as will cause the net income of a part to vary, in proportion to the mileage, with the net income of the whole. The implications of the formula being what they are, a taxpayer does not escape the application of the statute by evidence directed to only one of the related terms. Its evidence to be effective must be directed to each of them alike, for only by this can the assumed relation between them be proved to be unreal."—297 U. S. 682, 688.

Appellant has not made any effort to show any variance in California from the norm. If operations in California produced a loss whereas like operations elsewhere produced a profit, there must have been reasons for it, reasons which would give meaning and add substance to the bookkeeping loss shown by appellant's separate accounting system. No reason has been shown, nor has a single fact been shown which would tend to prove that the California operations or conditions differed from those found elsewhere. In the absence of a showing of exceptional conditions such as to negate the assumption that in California the relation between revenues and expenses is the same as it is in the other States in which appellant does business, a showing that the formula produces an improper result has not been made.

Appellant has not shown the source of its entire net income of over $1,000,000. For all that appears from the showing made by appellant, the use of

separate accounting allocation might allocate a loss to each of its stores in turn. If the factors which produce appellant's entire net income are present in the other States and absent from California, that fact has not been shown.

The facts as stipulated constitute appellant's entire showing, and they merely show that by the bookkeeping system which appellant used appellant computed a loss from its California operations. The bookkeeping system used by appellant was separate accounting, and, as we have heretofore shown, that accounting method does not tend to allocate accurately the net income of a unitary business. Furthermore, as we have shown, appellant's separate accounting accepts the formula method of allocation as to central expenses but rejects it in allocating other expenses and gross income; this inconsistency is the same as that which vitiated the attack on the formula in the *Norfolk & Western* case.

E. Formula allocation is the only practicable method of allocation

A decision sustaining the erroneous contention that a unitary business operating in seven States can be divided up by accounting into seven separate businesses, each with its own system of separate accounts and its own separate allocation of income, would be an incalculable threat to the survival of a system of state taxation of or measured by net income. In addition to being incurably fictitious,

such separate accounting is, unfortunately, open to manipulation by taxpayers desirous of evading their just taxes.

Such separate accounting requires that the figures in locally maintained books be used, yet invariably some of the items shown on the local books are mere reflections of figures and items developed at the central office and shown on the books there. Examples of this in the instant case are the cost of goods sold, the freight charges, and the central expenses. The accuracy of such figures cannot be verified by an inspection or audit of the local books, but only by an audit of the books maintained at the head office, or in the case of a manufacturing corporation at the factory, or both. As States do not have extraterritorial powers they cannot compel that these books, maintained at offices or plants outside their borders, be made available for their inspection and audit. Thus the States will have no way of checking the local books against entries in the central office books and will be at the mercy of the taxpayers.

We do not mean to suggest that appellant has been or would be guilty of such practices, but if a precedent be established upholding separate accounting allocation in this case, that precedent will certainly be used by other taxpayers, and if their local accounts be inaccurate that fact will not be ascertainable or provable by the taxing State.

Formula allocation is not susceptible to this manipulation. For instance, to operate the formula used herein both local and total tangible property, payroll and sales must be ascertained. The local figures are all truly local, i.e., they are not dependent on or a reflection of figures primarily shown on the books at the head office. Thus they may be fully verified by an audit of the local books. The figures representing the totals may all be verified from figures and information possessed and usually made available to the States by the Bureau of Internal Revenue.

Furthermore, use of a formula avoids reliance on such imponderables as fair market value. Where the State wherein a manufacturing plant or purchasing division functions wishes to allocate income to itself for tax purposes, or where a taxpayer wishes to allocate income to that State to avoid its being taxed elsewhere, if separate accounting allocation is to be used a fair market value of the goods will need to be determined. This value will not, however, be the retail value of the goods—it will be a figure intermediate between cost and retail value. It will necessarily be a fictional figure, not produced by the taxpayer's experience with these goods. Thus its use will often allocate fictitious, unrealized income to some States and equally fictitious losses to others. Furthermore, its use will introduce endless administrative difficulties and disputes unless

the decision of either the taxpayer or tax administrator is to be given the same finality that the assessment of the assessor or assessing body has in the field of property taxation.

The use of formula allocation avoids these difficulties and makes for more uniform, more practical tax administration.

II. The California Supreme Court did not err in refusing to reopen the case to permit appellant to show further facts, but had it erred that error would not have constituted a denial of due process

Paragraph 12 of the Stipulation of Facts (R-11, 12) provides that:

> ". . . if . . . the Court deems . . . that this stipulation fails to establish any fact necessary to a decision, the case shall be reopened for the taking of further proof in respect thereof."

This stipulation provides that the case shall be reopened for further evidence if the Court deems it necessary, not if appellant does. Appellant is objecting, therefore, because the California Supreme Court did not deem it necessary, but inasmuch as the stipulation left this in that court's discretion, its action is final.

Furthermore, we call attention to the fact that the further facts which appellant in its petition for rehearing below for the first time offered to prove are for the most part entirely foreign to appellant's

original theory of its case, which is that allocation by separate accounting is of itself sufficient evidence to overthrow a formula. The only facts which are not foreign to its original theory are those which would discount the importance of the central advertising, and as the court only relied incidentally on that feature, such additional showing would not have changed its decision.

Finally, we submit that the Constitution does not compel the courts of California to allow a case to be tried over and over on as many different theories as the ingenuity of counsel can devise. The procedure by which State courts dispense justice is not a federal question so long as a fair hearing and opportunity to be heard are afforded. (*Iowa Central Ry. Co.* v. *Iowa*, 160 U. S. 389, 393.) Surely a State court can compel litigants before it to comply with rules requiring the presentation of a litigant's entire case at one hearing. If this can not be done, all State rules regarding res judicata, splitting causes of action and defenses would be reviewable by this Court. Heretofore the only limitation placed by this Court on the power of the States to apply their own rules of this sort is in the field of class litigation, where the rule of res judicata has not been permitted to bind litigants unless they have been parties to or properly represented in the previous decision. (*Hansberry* v. *Lee*, 311 U. S. 32.) The situation

presented herein is not comparable to that presented by class litigation, for here appellant has throughout the proceeding been before the court and is a party to the litigation. The situation herein is comparable to the instances in which this Court has held that the rules of State courts requiring the presentation of contentions at certain times are not reviewable by this Court even though their application prevents the consideration of a federal question. (*Central Union Co.* v. *Edwardsville,* 269 U. S. 190; *John* v. *Paullin,* 231 U. S. 583; *Chesapeake & Ohio Ry. Co.* v. *McDonald,* 214 U. S. 190; *Hulbert* v. *Chicago,* 202 U. S. 275; *Jacobi* v. *Alabama,* 187 U. S. 133; *Iowa Central Ry. Co.* v. *Iowa,* supra; *Brown* v. *Massachusetts,* 144 U. S. 573.)

Appellant herein had the same opportunity to present evidence in the trial court that any other litigant has. There is nothing peculiar in the procedure in tax cases in the California courts. Appellee stipulated to the facts which appellant wished to establish, which constituted appellant's showing on its theory of the case. Thus appellant had an ample opportunity to present its case. After judgment in the trial court appellant did not move for a new trial or otherwise indicate that it wished to reopen the case. Instead appellant appealed to the California Supreme Court. That court might have remanded the case for the taking of additional evidence but it did not do so. It has

not expressed its reasons for that action, but it may have felt that to permit parties by stipulation to set aside the normal rules of procedure and allow a plaintiff to present its case piecemeal would unduly lengthen the course of litigation, thus encumbering and burdening the courts and delaying other litigants. In such a view to re-try the case would be contrary to the best interests of the public and therefore contrary to public policy. The due process clause does not, it is submitted, compel any other result.

CONCLUSION

A fair analysis of appellant's argument is that it must be allowed to use whatever method of keeping its books which it chooses, as the method for allocating its net income for tax purposes. The consequence of appellant's argument is that appellant be permitted to choose the basis for taxation which it itself chooses. The Constitution does not give appellant this privilege. The State is a sovereign with power to legislate, and the right to determine the basis of taxation to which appellant must submit belongs to the State, subject only to the requirement that the values which the State allocates to itself as the measure of the tax shall be fairly

proportioned to the business done in the State. The tax herein does not offend that requirement, so the judgment below, which so holds, is correct and should be affirmed.

Dated: January 5, 1942.

Respectfully submitted.

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APPENDIX

NORTH AMERICAN CEMENT CORPORATION

Albany, New York

Exhibit A—Segregation of Net Income Earned on Business Done in New York State and Outside New York State for the Year Ending December 31, 1927.

		New York State			Outside New York State		
	Total	Albany District	Howes Cave Plant	Catskill Plant	Hagerstown District	Security (Md.) Plant	Berkeley (W. Va.) Plant
Gross Profit	$1,634,202.10	$493,968.41	$292,707.00	$201,261.41	$1,140,233.69	$1,062,370.88	$77,862.81
Miscellaneous income	7,744.82	2,959.08			4,785.74		
	$1,641,946.92	$496,927.49			$1,145,019.43		
Selling and Administrative Expense—Cement	750,583.82[a]	422,653.75			327,930.07		
(Portion of expenses chargeable to each district is the ratio of cement shipped from each district to total cement shipped from all plants)							
Albany Dist.							
Howes Cave 740,868							
Catskill 1,166,557							
Total N. Y. State 1,907,425—56.31%							
Security (Md.) 1,480,170—43.69%							
Total all plants 3,387,595 bbls.							
Selling and Administrative Expense—Line (W. Va.)	84,452.00				84,452.00		
Operating profit	$806,911.10	$74,273.74			$732,637.36		
Interest and financial expense, including interest on debentures and amortization of discount	542,215.91[b]	276,211.35			266,004.56		
	$264,695.19	$(201,937.61)			$466,632.80		
Add: Non-deductible items:							
Increase in reserve for insurance	3,231.90				3,231.90		
Increase in reserve for repairs	303.94				303.94		
Taxes paid on Company tax free bonds	4,432.47	2,257.90 (50.94%)			2,174.57 (49.06%)		
	$272,663.50	$(199,679.71)			$472,343.21		

(a) Selling and administrative expense—Total		$843,498.13
Add: Interest on bank loans, etc.		21,452.70
		864,950.83
Deduct: Miscellaneous general income		29,915.01
		$835,035.82
Berkeley plant district expense	70,452.00	
Portion of general administrative expenses applied to Berkeley	14,000.00	
(See L. R. B. & M. certificate to Empire Trust Co.)		
Total lime dept. selling and administrative expense		$84,452.00
Applied to cement		$750,583.82
(b) Total property values in New York State and outside New York State at December 31, 1926, when the major construction program had been completed, and for which the proceeds of the 6½% debentures were used		$14,713,435.10
Deduct: Catskill plant		4,716,249.17
Balance, representing value of Howes Cave, (N. Y.) plant and Security (Md.) and Berkeley (W. Va.) plants		$9,997,186.93
Howes Cave (N. Y.) plant	35.29%	$3,527,846.01
Security (Md.) and Berkeley (W. Va.) plants	64.71%	6,469,340.92
		$9,997,186.93
Total bond interest and amortization		$542,215.91
Deduct: Catskill plant (See L. R. B. & M. statement attached for amount allotted to the Catskill plant)		131,144.11
Balance to be allotted to operations of Howes Cave (N. Y.) plant and Security (Md.) and Berkeley (W. Va.) plants		411,071.80
Howes Cave (N. Y.)—36.29%	$411,071.80	$145,067.24
Catskill (N. Y.) plant		131,144.11
Total New York State	50.94%	276,211.35
Outside New York State—64.71%	$411,071.80	
	49.06%	266,004.56
		$542,215.91
Tax assessed as follows:		
Gross assets—% N. Y. State	56.777%	
Taxable net income (272,663.50 x 56.777%)		$154,810.16
Tax at 4½%		6,966.45
Notice of assessment dated 12/27/28—File No. A-657409		
Date tax paid—Jan. 15, 1929 (Receipt dated 2/11/29).		

NORTH AMERICAN CEMENT CORPORATION

Income Account for the Catskill Plant for the year ended December 31, 1927

Sales, net of returns, allowances and discounts			$1,655,959.98
Cost of sales			1,454,698.57
Gross profit			201,261.41
Add: Miscellaneous plant income			1,179.47
			202,440.88
Selling and administrative expenses		$843,498.13	
Interest on bank loans, etc		21,452.70	
		864,950.83	
Less:			
Miscellaneous general income	$29,915.01		
Berkeley plant district expenses	70,452.00		
Portion of general administrative expenses applied to Berkeley plant	14,000.00		
		114,367.01	
		$750,583.82	
Portion of expense chargeable to Catskill 34.44% the ratio of cement shipped from Catskill to total cement shipped from all plants			258,501.07
Operating profit			56,060.19
Interest and financial expense, including interest on debentures and amortization of discount, 21.7% of $524,995.91 (21.7% represents the ratio $1,650,000 par value of 6½% debentures to the total outstanding February 11, 1926, of $7,597,000). Additions to plant facilities February 11, 1926, to December 31, 1926, totaled approximately $1,875,000		$113,925.11	
Interest on first mortgage 6% bonds for year ended December 31, 1927		17,220.00	131,144.11
Net loss		(Deficit)	187,304.30

We have examined the accounts and records of the North American Cement Corporation for the year ended December 31, 1927. Based upon this examination we certify that, in our opinion, the

above statement fairly reflects the results of the operations of the Catskill plant for the year ended December 31, 1927.

Lybrand, Ross Bros. & Montgomery,
Accountants and Auditors.

New York, January 23, 1928.

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SUPREME COURT OF THE UNITED STATES.

No. 283.—October Term, 1941.

Butler Brothers, Appellant, *vs.* Charles J. McColgan, as Franchise Tax Commissioner of the State of California.	Appeal from the Supreme Court of the State of California.

[March 2, 1942.]

Mr. Justice Douglas delivered the opinion of the Court.

This is an appeal (Judicial Code § 237(a), 28 U. S. C. § 344(a)) from a final judgment of the Supreme Court of California sustaining the validity of a statute of California against the claim that as construed and applied to appellant it violated the Fourteenth Amendment. 17 Cal. 2d 664, 111 Pac. 2d 334. The statute in question is the Bank and Corporation Franchise Tax Act. 2 Gen. L., Act 8488, p. 3851; Stat. 1929, p. 19; amended, Stat. 1931, p. 2226; Stat. 1935, p. 965. Sec. 4(3) of that Act provides for an annual corporate franchise tax payable by a corporation doing business within the State. The tax is measured by the corporation's net income and is at the rate of four per cent "upon the basis of its net income" for the preceding year. The minimum annual tax is $25. Sec. 10 prescribes the method for computing the net income on which the tax is laid. It provides in part:

"If the entire business of the bank or corporation is done within this State, the tax shall be according to or measured by its entire net income; and if the entire business of such bank or corporation is not done within this State, the tax shall be according to or measured by that portion thereof which is derived from business done within this State. The portion of net income derived from business done within this State, shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacturer, pay roll, value and situs of tangible property, or by reference to these or other factors, or by such other method of allocation as is fairly calculated to assign to the State the portion of net income reasonably attributable to the business done within this State and to avoid subjecting the taxpayer to double taxation."

The tax in dispute is for the calendar year 1936. Appellant paid the minimum tax of $25, asserting that it operated in California during 1935 at a loss of $82,851. The tax commissioner made an additional assessment of $3,798.43 which appellant paid, together with interest, under protest. This suit was brought to recover back the amount so paid on the theory that the method of allocation employed by the tax commissioner attributed to California income derived wholly from business done without that State.

The facts are stipulated and show the following. Appellant is an Illinois corporation qualified to do business in California. Its home office is in Chicago, Illinois. It is engaged in the wholesale dry goods and general merchandise business, purchasing from manufacturers and others and selling to retailers only. It has wholesale distributing houses in seven states, including one at San Francisco, California. Each of its houses in the seven states maintains stocks of goods, serves a separate territory, has its own sales force, handles its own sales and all solicitation, credit and collection arrangements in connection therewith, and keeps its own books of account. For the period in question, all receipts from sales in California were credited to the San Francisco house. Appellant maintains a central buying division through which goods for resale are ordered, the goods being shipped by manufacturers to the houses for which they are ordered. All purchases made by appellant for sale at its various houses are made through that central buying division. The cost of the goods and the transportation charges are entered on the books of the house which receives the goods. No charges are made against any house for the benefit of appellant or any of its other houses by reason of the centralized purchasing. But the actual cost of operating the centralized buying division is allocated among the houses. The greater part of appellant's other operating expenses is incurred directly and exclusively at the respective houses. Certain items of expense are incurred and paid by appellant for the benefit of all the houses and allocated to them. No question exists as to the accuracy of the amounts of such expense or the method of allocation. The latter admittedly followed recognized accounting principles. For the year 1935 the amount of such allocated expense charged to the San Francisco house was $100,091. For purposes of this suit it was agreed that approximately 75% of that amount would have been

incurred even though the San Francisco house was not operated. The accuracy and propriety of the basis of allocation of those common expenses for 1935 were admitted. Included in such expenses were executive salaries, certain accounting expenses, the cost of operating a central buying division, and a central advertising division. Except for such common expenses, each house is operated independently of each other house. Appellant computed its income from the San Francisco house for the period in question by deducting from the gross receipts from sales in California the cost of such merchandise, the direct expense of the San Francisco house, and the indirect expense allocated to it. By that computation a loss of $82,851 was determined. In the year 1935 the operations of all houses of appellant produced a profit of $1,149,677. The tax commissioner allocated to California 8.1372 per cent. of that amount. That percentage was determined by averaging the percentages which (a) value of real and tangible personal property, (b) wages, salaries, commissions and other compensation of employees, and (c) gross sales, less returns and allowances, attributable to the San Francisco house bore to the corresponding items of all houses of appellant. No other factor or method of allocation was considered. The propriety of the use of that formula is not questioned if by reason of the stipulated facts a formula for allocation to California of a portion of appellant's income from all sources is proper.

The stipulation also states that in the year 1935 the total sales made by appellant at all its houses amounted to $66,326,000, of which $5,206,000 were made by the San Francisco house. The purchases made for the account of that house were substantially in the same proportion to total purchases. By reason of the volume of purchases made by appellant "more favorable prices are obtained than would be obtainable in respect of purchases for the account of any individual house". The addition of purchases "in an amount equal to the purchases made for the account of the San Francisco house results in no more favorable prices than could be obtainable in respect of purchases in an amount equal to the purchases which would be made" by appellant for its other houses if the San Francisco house was not in existence; and "a reduction in the volume of purchases in an amount equal to the purchases made for the San Francisco house would result in no less favorable prices being obtainable in respect of the purchases which would be made for the remaining houses" of appellant.

Hans Rees' Sons, Inc. v. *North Carolina*, 283 U. S. 123, constitutes appellant's chief support in its attack on the formula employed and the tax imposed by California. Appellant maintains that the use of the formula in question resulted in converting a loss of $82,851 into a profit of over $93,500 and that the difference of some $175,000 has either been created out of nothing or has been appropriated by California from other states.

We take a different view. We read the statute as calling for a method of allocation which is "fairly calculated" to assign to California that portion of the net income "reasonably attributable" to the business done there. The test, not here challenged which has been reflected in prior decisions of this Court, is certainly not more exacting. *Bass, Ratcliff & Gretton, Ltd.* v. *Tax Commission*, 266 U. S. 271; *Ford Motor Co.* v. *Beauchamp*, 308 U. S. 331. Hence if the formula which was employed meets those standards, any constitutional question arising under the Fourteenth Amendment is at an end.

One who attacks a formula of apportionment carries a distinct burden of showing by "clear and cogent evidence" that it results in extraterritorial values being taxed. See *Norfolk & Western Ry. Co.* v. *North Carolina*, 297 U. S. 682, 688. This Court held in *Hans Rees' Sons, Inc.* v. *North Carolina, supra*, p. 135, that that burden had been maintained on a showing by the taxpayer that "in any aspect of the evidence" its income attributable to North Carolina was "out of all appropriate proportion to the business" transacted by the taxpayer in that State. No such showing has been made here.

It is true that appellant's separate accounting system for its San Francisco branch attributed no net income to California. But we need not impeach the integrity of that accounting system to say that it does not prove appellant's assertion that extraterritorial values are being taxed. Accounting practices for income statements may vary considerably according to the problem at hand. Sanders, Hatfield & Moore, A Statement of Accounting Principles (1938), p. 26. A particular accounting system, though useful or necessary as a business aid, may not fit the different requirements when a State seeks to tax values created by business within its borders. Cf. Hamilton, Cost as a Standard for Price, 4 Law & Contemporary Problems 321. That may be due to the fact, as stated by Mr. Justice Brandeis in *Underwood Typewriter Co.* v. *Chamberlain*, 254 U. S. 113, 121, that a State in attempting to

place upon a business extending into several States "its fair share of the burden of taxation" is "faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders." Furthermore, the particular system used may not reveal the facts basic to the State's determination. *Bass, Ratcliff & Gretton, Ltd.* v. *Tax Commission, supra*, p. 283. In either aspect of the matter the results of the accounting system employed by appellant do not impeach the validity or propriety of the formula which California has applied here.

At least since *Adams Express Co. v. Ohio*, 165 U. S. 194, this Court has recognized that unity of use and management of a business which is scattered through several States may be considered when a State attempts to impose a tax on an apportionment basis. As stated in *Hans Rees' Sons, Inc.* v. *North Carolina, supra*, p. 133, " . . . . the enterprise of a corporation which manufactures and sells its manufactured product is ordinarily a unitary business, and all the factors in that enterprise are essential to the realization of profits." And see *Bass, Ratcliff & Gretton, Ltd.* v. *Tax Commission, supra*, p. 282. By the same token, California may properly treat appellant's business as a unitary one. Cf. *Great Atlantic & Pacific Tea Co.* v. *Grosjean*, 301 U. S. 412. There is unity of ownership and management. And the operation of the central buying division alone demonstrates that functionally the various branches are closely integrated. Admittedly, centralized purchasing results in more favorable prices being obtained than if the purchases were separately made for the account of any one branch. What the savings were and what portion is fairly attributable to the volume contributed by the San Francisco branch do not appear. But the concession that a reduction or addition of purchases "in an amount equal to the purchases made for the San Francisco house" would not result in higher or lower purchase prices respectively does not aid appellant's case. There is no justification on this record for singling out the San Francisco branch rather than another and concluding that it made no contribution to those savings. As aptly stated by the Supreme Court of California, "If the omission of the California sales would have no effect on the purchasing power, the omission of sales in an equal amount wherever made would likewise have no effect on the company's ability to purchase at a saving. Thus, by proceeding in turn from state to state, it could be shown that none of the sales in any of the states should be credited with the income resulting

from the purchasing of goods in large quantities." Nor are there any facts shown which permit the conclusion that the other advantages of centralized management (*Great Atlantic & Pacific Tea Co.* v. *Grosjean, supra*) are attributable to other branches but not to the one in California. The fact of the matter is that appellant has not shown the precise sources of its net income of $1,149,677. If factors which are responsible for that net income are present in other States but not present in California, they have not been revealed. At least in absence of that proof, California was justified in assuming that the San Francisco branch contributed its aliquot share to the advantages of centralized management of this unitary enterprise and to the net income earned.

We cannot say that property, pay roll, and sales are inappropriate ingredients of an apportionment formula. We agree with the Supreme Court of California that these factors may properly be deemed to reflect "the relative contribution of the activities in the various states to the production of the total unitary income", so as to allocate to California its just proportion of the profits earned by appellant from this unitary business. And no showing has been made that income unconnected with the unitary business has been used in the formula.

The stipulation of facts states that if "the Court deems that it is bound by any inference or presumption respecting the assessment made by the Commissioner, or that this stipulation fails to establish any fact necessary to a decision, the case shall be reopened for the taking of further proofs in respect thereof." Appellant in its petition for rehearing before the Supreme Court of California relied on that part of the stipulation in urging that the cause be remanded for a further hearing since that Court concluded that "appellant has not furnished any explanation of why its California business differs so from the average that the formula produced an erroneous result." The petition for rehearing was denied. Appellant now asserts that it has been denied procedural due process under the rule of *Saunders* v. *Shaw*, 244 U. S. 317. We do not agree. The Supreme Court of California created no innovation and sprung no surprise when it placed on appellant the burden of establishing that the formula taxed extraterritorial values. As we have noted, that is settled doctrine. Appellant had a full opportunity to be heard on the issues which it tendered.

Affirmed.